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A marketplace of choices

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Abstract (Article Summary)

A number of major mortgage lenders now deliver their product information to the point of sale using the MARS system (a computerized loan origination system offering loan price quotes and terms for multiple lenders). This allows them to define product, pricing, and underwriting niches in virtually any degree of detail. Nichification is driven by the secondary market, which prices every borrower, property, or transaction characteristic that is believed to be related to default risk, prepayment risk, or servicing cost. Secondary markets also stimulate nichification by creating easy entry into the home lending market by mortgage bankers and mortgage brokers. Nichification raises serious questions about the validity of existing price comparisons across lenders or geographic areas because these comparisons apply to no generally accepted base product. Nichification bodes well for the future of multilender networks that will offer both widespread coverage of market niches and a recognizable identity associated with the network sponsor.

Full Text (3379 words)

[Headnote]
Computer systems that list lenders' products side by side don't promote cutthroat competition just on price. Instead, these systems promote competition in a wide variety of product niches.

YOU'VE HEARD IT OFTEN. "DELIVERING LOANS BY COMPUTER, WHERE consumers can compare prices side by side on the screen, results in commoditization. Consumers select the best price, and everything else-including service-goes out the window."

To appreciate why this is a myth, consider the data in Figure 1. It is a table that lists actual price quotations from April 24, 1996, covering 30-year conventional fixedrate mortgages (FRMs) posted by 13 lenders (denoted A through M). These lenders had their products listed on the MARS System. (MARS is a computerized loan origination system offering loan price quotes and terms for multiple lenders.)

Figure 1 is limited to 30-year FRMs, which are viewed as the most commoditized of all home loan types. For each of the market niches shown on the table, I found the lender or lenders offering the best deal. I defined the best deal as the smallest number of points for a given rate or the lowest rate for a given number of points.

Of the 13 lenders covered, 12 are represented on the table, meaning that each of the 12 offered the best deal in at least one significant market niche.

What Figure 1 illustrates is something I call nichification-the modification of prices and **underwriting** requirements for an extraordinarily large number of combinations of transaction, borrower and property characteristics. Nichification is in some sense the opposite of commoditization. Commoditization implies something akin to the economist's concept of perfect competition, where large numbers of sellers generate a single price from which none can diverge. The notion of nichification implies substantial pricing discretion, because the number of competitors within any niche is much smaller, and borrowers have great difficulty making price comparisons within niches.

Until now, information about market niches has been scant. Only product niches have received any attention, but even here the available information is quite incomplete. However, a number of major lenders now deliver their product information to the point of sale using the MARS System, which allows them to define product, pricing and underwriting niches in virtually any degree of detail. This information, which is generally updated daily, is stored in a central data base (the MARS Clearinghouse) and is a potential treasure trove of information on the structure and competitive characteristics of the home loan market.

While the lenders providing this information do not constitute a representative sample of the market-large lenders are disproportionately represented-the market segment they represent is important in its own right and growing. As of April 30, 1996, there were 25 lenders represented on the system that originated about $80 billion in loans in 1995.

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This article is a first report on market niches using the MARS data base. It barely scratches the surface of what is there, but it illustrates the potential application of this information and hopefully paves the way for more definitive analyzes.

What is a market niche?

The prevailing view of niches is that they are departures from a standard set of specifications. Loans that are consistent with the standard specifications constitute the generic market, and those that do not are niche products.

The standard specifications include the following: * Collateral is a single-family home. * Borrower is purchasing the home for his or her principal residence.

* Borrower is a U.S. citizen and an A (or perhaps A-) credit. * Standard loan documentation is used.

On the other hand, there is no standard type of loan, loan size, loan-to-value ratio (LTV), rate or points, or lock period. Lenders are all over the lot on these.

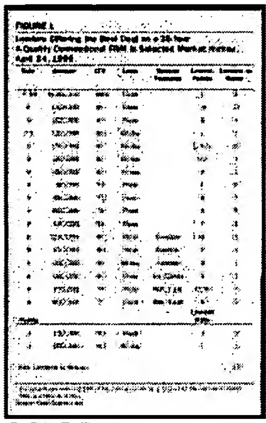

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FIGURE 1

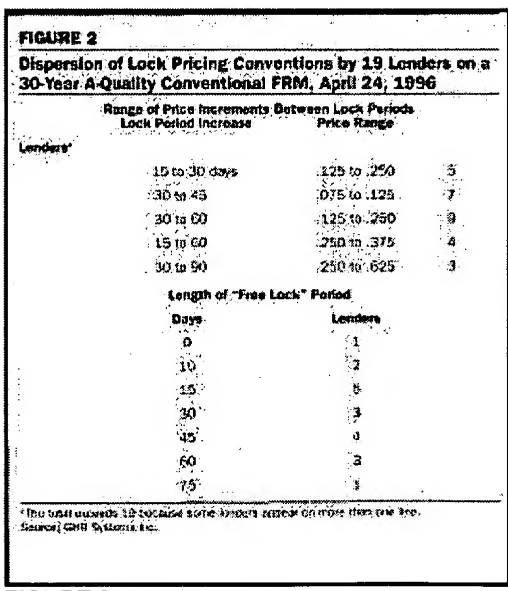

FIGURE 2

Dispersion of Lock Pricing Conventions by 19 Lenders on a 30-Year A-Quality Conventional FRM, April 24, 1996

Range of Price Increments Between Lock Periods

Lock Period Increase	Price Range	Lenders*
15 to 30 days	.125 to .250	5
30 to 45	.075 to .125	7
30 to 60	.125 to .250	9
15 to 60	.250 to .375	4
30 to 90	.250 to .625	3

Length of "Free Lock" Period

Days	Lenders
0	1
10	2
15	5
30	3
45	0
60	2
75	1

*The total exceeds 19 because some lenders appear on more than one line.
Source: GHR Systems, Inc.

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FIGURE 2

As an illustration, lenders using the MARS System who offer more than one rate/point combination specify one combination as the base, which is the combination that appears on the screen if the loan counselor doesn't specify some other selection rule (such as a specific rate, specific points, lowest rate or lowest points). There is no convention regarding how the base combination is selected, however, so one lender might select the rate closest to zero points, while another might select the lowest rate/highest point combination.

Because the set of standard specifications is not complete, market niches must be defined as any bundle of borrower, property and transaction characteristics that lenders recognize in their pricing and/or their underwriting requirements. It follows that the home loan market cannot be characterized as a large core market associated with a generic home loan surrounded by many specialized but small market niches. My contention is that there is no

generic product. The market is a collection of niches, period.

How many market niches are there?

I believe the data shows that there are an enormous number of market niches. Using numbers typical of lenders on the MARS System, for any one type of mortgage there may be 12 rate/point combinations and five lock periods, generating 60 niches right off the bat. Figuring in five loan-size categories raises it to 300. Adding four credit-quality categories (A through D paper), four levels of required documentation and the four LTV groups used by private mortgage insurers raises the number of niches to 19,200. Eight property categories (one-, two-, three- and four-family; co-op; condo; manufactured and PUD), three occupancy categories (full-borrower occupancy, nonoccupant co-borrower and second home), and three loan purposes (purchase, no-cash refinance and cash-out refinance) raise the number of niches to 1,382,400.

And this does not take into account the large number of mortgage product types and options. For example, I recently identified 41 different types of ARMs being offered by lenders on MARS. Some lenders offered one or a few ARMs, some a larger group, but no one lender offered all of them. No lender even tries to operate in every niche.

Of course, some niches promise to generate much more loan volume than others, and some don't represent any practical business opportunities. For example, no lender will offer a no-doc loan to a D-credit borrower. But even if we threw out all the empty cells, the number remaining is staggeringly large.

And it is going to get larger. As noted below, nichification is driven by the secondary market, which prices every borrower, property or transaction characteristic that is believed to be related to default risk, prepayment risk or servicing cost. Originators pass these pricing adjustments through to the primary market. Since the information base and the research that underlies judgments about risk and cost are continually improving, nichification will continue to expand.

Competition within niches

Even for 30-year FRMs, viewed as the most generic or standardized of all mortgage loan types, lenders have considerable discretion as to how they price important features of the loan contract. This discretion exists because the 30-year FRM is not in fact a generic product. It is actually offered in a large number of market niches, some of which have few lenders. For example, Figure 1 shows that in 16 of 19 niches no more than six of the 13 lenders were represented, and in 10 niches there were three lenders at most.

It is not surprising, then, that the tendencies toward price uniformity suggested by the commoditization thesis are difficult to find in the pricing behavior we see evident on the MARS System. Lock-period pricing conventions, for example, differ widely. This is illustrated by Figure 2, which covers six retail lenders in addition to the 13 wholesalers covered in Figure 1. The upper part of the table shows differences between lenders in the price increments they charge to extend the lock period. The first line, for example, shows that five lenders quoted prices for both 15- and 30-day lock periods. Some charged .125 points more for the longer lock, while others charged .250 more for the longer period. The largest difference occurred in connection with an extension from 30 to 90 days, which only three lenders offered.

All lenders except one offered a free lock period, meaning that they do not charge extra for a lock of that length, relative to a shorter lock period, or a "float." Among 18 lenders, the free-lock period ranged from 10 to 75 days. Clearly, lenders are using lock pricing as a way of differentiating themselves within market niches.

On September 11, I took another look at rate-lock pricing and its relationship to rate/point pricing. On a $150,000 30year conforming FRM with 80 percent LTV, I found six lenders I will denote A-F quoting a rate of 7.875 percent (among other rates). For locks of 60 days or shorter, lender A charged the fewest points (1.50 to 1.75). For a 75-day lock, lender C charged the fewest points (2). For a 90-day lock, lenders C and D charged the fewest points (2). And for a 120day lock, D charged the fewest points (3).

Lenders B, E and F don't score in any of the niches stipulated above. But suppose the borrower needs a 60-day lock with -2 points. (Negative points mean that the lender pays to offset the borrower's settlement costs up to the amount of the negative points. Only lenders E and F offered this combination (at 9 percent), and if the borrower required a 90-day lock with -2 points, it was available only from lender F.

ARM Niches

ARM niches can be defined in terms of different types of ARMs, or in terms of the various borrower characteristics to which the ARMs are targeted. These include preferences for low initial payments, time horizon, degree of aversion to the risk of rising future rates and payments and the relative priority given to payments and interest cost.

Figure 3 provides performance information on nine types of ARMs defined in terms of the period that the initial rate holds and the subsequent rate adjustment period. For example, on the 3M/1M the initial rate holds for three months, after which the rate adjusts monthly. The performance information includes payments and interest cost over varying periods, on no-change and worst case interest rate assumptions.

These ARMs can be matched against bundles of borrower characteristics. For example, borrowers with either strong preference for low initial payments or low risk aversion will opt for products A, B or C. Among the three, the borrower looking for the longest stretchout of the payment increase on a nochange scenario will opt for A. Borrowers with high risk aversion will opt for product H if their time horizon is three years, product I if it is five years, product F if it is seven years and product G if it is 10 years. Products D and E are for borrowers with short time horizons but less risk aversion than those selecting H and I. **Borrowers** likely to **pick** ARM products H and I are willing to take a chance on doing somewhat worse in a worst-case scenario in order to do somewhat better in a no-change scenario.

These nine types of ARMs clearly reflect well-defined market niches, with many lenders operating in some of the product niches (the 1/1) and few in others (the 10/1, for example). Within fairly wide limits, loans in one niche compete only with other loans in that niche.

In addition, there are numerous subniches within any given loan product type. For example, alongside product G is another 10/1 ARM with a higher initial rate but a lower ceiling, offering the borrower an opportunity to pay a slightly higher rate for 10 years but take less risk in terms of the rate increase at the end of that period. (The ceiling rate is the maximum rate allowed in the loan contract.) This must be viewed as a different product than G, aimed at borrowers with greater risk aversion, a longer time horizon or both. Because this product is closer to the other 10/1 than to other types of ARMs, however, the lender's freedom to price it advantageously is constrained more by the pricing on the other 10/1s than by the pricing on other types of ARMs.

This brief analysis only scratches the surface in terms of examining product competition in the various ARM niches.

Market pressures toward nichification

To date, so far as I can determine, this trend of mortgage product nichification has been restricted to the United States. It has not developed in Canada, for example. A plausible explanation is that the reasons have to do with the major differences between the home loan market in the United States and everywhere else. Specifically, it most likely stems from the more advanced development of secondary markets in the United States, and the associated greater intensity of competition. In Canada and other countries, portfolio lending still dominates and competition is less intense.

Secondary markets stimulate nichification by creating a demand for information bearing on the risk and cost of different borrower, property and transaction characteristics, which can be of value in secondary market pricing. These prices are then transmitted back to the primary market through loan originators who sell into the secondary market. If the secondary market determines that loans to nonoccupants are riskier than loans to occupants, for example, rating agencies will require more insurance coverage on pools containing such loans, conduits will pay less for them (or impose correspondingly tougher **underwriting** requirements on them), and lenders who sell in the secondary market will be obliged to lower their prices and/or tighten their **underwriting** requirements accordingly.

I realize that this view contradicts the conventional wisdom that secondary markets, and especially those dominated by the major agencies, promote commoditization by creating uniformity in **underwriting** rules. But the fact is that the agencies have not created uniform **underwriting** rules, as even a cursory look at their **underwriting** guidelines will show. A large proportion of the borrower, property and transaction characteristics referred to earlier that define market niches are found in these guidelines! What the agencies have done is to standardize the **underwriting** rules, which is quite different from making them uniform. In addition, much of the nichification that we see is associated with factors bearing on prepayment risk or servicing cost, which are not related to **underwriting** rules.

In a portfolio lending regime, in contrast, there seems not to be the same compelling pressure to identify the sources of risk and cost in the loan portfolio. The institutions generally understand that they are engaging in extensive cross-subsidization between different categories of customer, but since their rivals do the same, there is no pressure to incur the costs involved in making a change. These costs include the research required to determine how various borrower, property and transaction characteristics are related to risk and cost, and the systems development required to incorporate the findings into lending procedures.

Portfolio lenders in a system with a well-developed secondary market, however, must practice nichification, or they will be in trouble. Suppose, for example, that new information discloses that some previously unsuspected property characteristic-tile floors, for example-is related to risk. Originators that sell into the secondary market will immediately raise the rate on loans secured by properties with tile floors, and if portfolio lenders don't do the same,

in time all the tile-floor home loans will gravitate to them. Many portfolio lenders will be slow to catch on to this, but those who survive this adverse selection will have made the adjustment.

Secondary markets also stimulate nichification by creating easy entry into the home lending market by mortgage bankers and mortgage brokers. In a competitive market with easy entry, there is a pervasive tendency for lenders to seek a competitive edge that will increase market share. One way to do this is to find overlooked or underserved niches. For example, the fact that most lenders historically avoided loans that were viewed as very risky provided opportunities for other lenders to specialize in these niches if they could find a way to effectively manage and price the risk. This led to the development of the so-called B-D market. The specialized lenders had few competitors, and many earned a higher-than-normal rate of return for a long period. As other lenders have crowded into this market, the returns have come down, but they are still higher than in the mainstream conforming mortgage credit business.

Additional underserved niches were particular rate/point combinations that appealed to borrowers, as opposed to the traditional single combination that lenders were accustomed to offering. Borrowers who are fixated on their mortgage payment obligation tend to focus on a desired rate. Other borrowers fixated on the cash needed to close focus on a desired number of points. Lenders that catered to both groups by offering a range of rate/point combinations found they could increase their market share. Multiple rate/point combinations (and on ARMs, multiple rate/point/ceiling combinations) have replaced the single combination similar to the way that multiple colors on automobiles replaced the once-ubiquitous black.

Invalidity of price comparisons across lenders and areas

Nichification raises serious questions about the validity of existing price comparisons across lenders or geographic areas because these comparisons apply to no generally accepted base product. For example, should the price of the base product be set for an 8 percent rate or for a 9 percent rate? Should it be for a $150,000 loan or a $350,000 loan? Would it be for a commitment where the price floats with the current market or for a commitment where the lender guarantees the rate for 60 days?

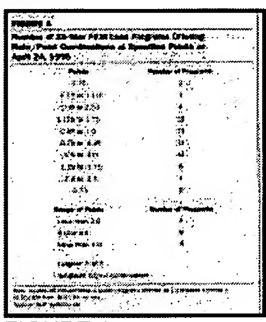

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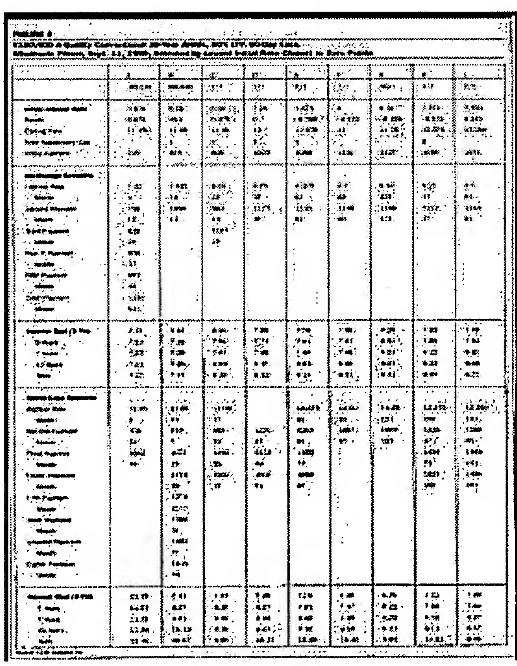
FIGURE 4



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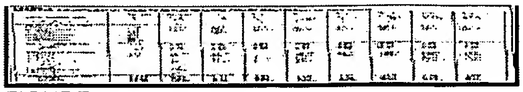


FIGURE 3

There is no natural definition of a base product, which means that market quotations and cross-market comparisons that do not explicitly define the market niche they refer to can be highly misleading.

A good example is data reported in Consumer Reports for May 1996, which shows a single combination of rates and points for 30-year FRMs and one-year ARMs for selected lenders in 25 cities. Because the data does not specify the loan amount, lock period, LTV or anything else, it is meaningless.

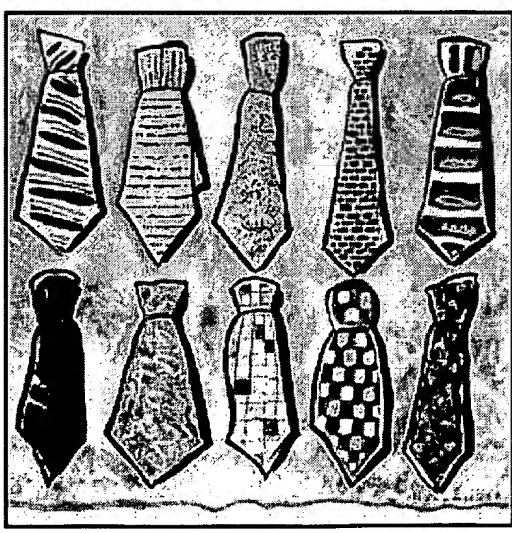
Another implication

Figure 1 dramatically illustrates the advantage of a multilender delivery system. None of the 13 lenders covered in the figure offered the best deal in more than three of the 19 market niches. The ability to take advantage of this is undoubtedly a major factor underlying the rapid growth of mortgage brokers in recent years. Representing multiple wholesalers, mortgage brokers can often offer customers a better deal than can retail loan officers delivering the products of a single lender. This has more than offset the primary disadvantage of mortgage brokers: that they present no recognizable identity to borrowers.

Nichification bodes well for the future of multilender networks that will offer both widespread coverage of market niches and a recognizable identity associated with the network sponsor. The first major venture of this type, The Home Mortgage Network of Vernon Hills, Illinois, is in the process of rolling out a MARS-based multilender computerized loan origination system at Coldwell Banker, Mission Viejo, California. Since Coldwell Banker is now owned by HFS, Parsippany, New Jersey, which also owns Century 21, it is expected that The Home Mortgage Network may soon extend its operations to Century 21.

To carry out a competitive strategy based on nichification, information must be transferred from lenders' back offices to multiple points of sale, where the terms applicable to a particular transaction must be retrieved. The process cannot go very far in a manual world before the errors in transmission, the time required to find the terms applying to a particular transaction at the point of sale, and the frequency of mistakes in doing all this rise to the point where the costs exceed the benefits.

The new technology changes all this. Technology of the type embedded in the MARS System makes it possible for lenders to define their product, pricing and **underwriting** niches at the back-office level in virtually any degree of detail they wish. Then it allows them to transmit the data to the point of sale, errorfree, and have loan counselors retrieve the terms applicable to a particular transaction quickly and accurately. Hence, the nichification already apparent today may be just a taste of what is to come.



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[Author Affiliation]
Jack Guttentag is emeritus professor of finance at the Wharton School of the University of Pennsylvania and chairman of GHR Systems, developers of MARS, in Wayne, Pennsylvania.